



July 25, 2005

Governor M. Jodi Rell
Executive Office of the Governor
State Capitol
210 Capitol Avenue
Hartford, CT 06106

Governor Mitt Romney
State House
Office of the Governor
Room 360
Boston, MA 02133

Governor Donald L. Carcieri
Office of the Governor
State House, Room 115
Providence, RI 02903

Governor John Baldacci
Office of the Governor
#1 State House Station
Augusta, ME 04333-0001

Governor John Lynch
Office of the Governor
State House
25 Capitol Street
Concord, NH 03301

Governor Jim Douglas
109 State Street, Pavilion
Montpelier, VT 05609-0101

Dear Governors:

I am writing to respond to concerns you have recently expressed regarding ISO New England's proposal to fix the region's flawed capacity market.

Fixing the Problem

We recognize, and take very seriously, the concerns raised in your letter regarding the plan for Locational Installed Capacity (LICAP). Needless to say, we strive to achieve consensus with all stakeholders on significant market changes, such as LICAP, and prefer when that is accomplished.

While there is significant opposition to the LICAP plan, we do believe there is recognition among stakeholders that a flaw exists in the market today that must be addressed, or we risk serious, costly reliability problems in the not too distant future. Additionally, we share your objective to develop an effective market that can provide an adequate supply of resources at the lowest cost to consumers.

As you know, we firmly believe our proposal is consistent with these principles, and disagree with any approach that either delays action until the region is on the verge of region-wide electricity shortages or maintains a band-aid approach to paying for needed capacity. However, in response to their request, we are willing to provide technical resources to the New England Conference of Public Utilities Commissioners in order to assist them in their efforts to develop potential alternatives.

ISO New England Inc.

One Sullivan Road, Holyoke, MA 01040-2841

www.iso-ne.com T 413 535 4000

Background

Today's markets cannot adequately compensate existing resources (including power plants, demand response programs and conservation) and attract new resources. The flaw, in large part, was created when price caps were placed on the New England markets in 2000, after prices rose to over \$6,000 per megawatt hour in May of that year. While price spikes are very problematic for consumers and suppliers, they provide the appropriate revenues to all the resources that are needed to keep all the lights on during periods of shortage. LICAP is designed as a spot market signal to replace the lost revenue in a more stable, efficient, and less costly manner, and to provide a mechanism for signaling the need for new investment.

Unless a market-based solution is developed to provide incentives for this investment, we face a massive growth in costly out-of-market contracts (to compensate existing resources needed for reliability and to procure new resources), and an inexorable move back to regulated generation investments—a policy that the region soundly rejected in the late 1990's. While I understand your concern about the costs of LICAP, please understand that, if LICAP does not go forward, consumers will nonetheless have to pay for existing and new capacity in some manner.

I also understand that one of the major concerns of those opposing our proposal is that there is no "guarantee" that capacity will be built. Capacity will only be built when there is adequate compensation in the marketplace. The lack of a "guarantee" is not unique to LICAP; it is true in all competitive markets. When the region deregulated the generation sector, the change was based on the belief that markets would work to cause efficient operation and investment when needed. This belief proved true and a significant number of combined cycle gas plants have been built over the last several years and power plant availability has increased significantly, saving consumers hundreds of millions of dollars each year. However, the initial investment which occurred was based on the assumption that the market will return the long run cost of capital investment. This has not proven to be the case due to the market flaw I described and hence development will not recur, nor will efficient operation be improved, until we remedy this flaw. To the extent that states require a higher degree of confidence regarding monies paid for resources provided, the LICAP proposal does not prevent each state from entering into long-term contracts for adequate resources, as Connecticut is considering.

Nonetheless, the ultimate decision on the appropriate solution to this problem resides with the Federal Energy Regulatory Commission. We are hopeful that they will issue an order and further direction on this matter within a few months. In the meantime, we look forward to a continuing dialogue with you and your office on issues of concern to the ongoing evolution of the wholesale electric markets in New England.

I am encouraged by the involvement of the governors, state utility commissions, consumer advocates, and attorneys general on an issue of critical importance to the region's future electric service reliability. ISO New England is willing to work with you, and all New England stakeholders, on these issues, including through the provision of technical resources to the New England Conference of Public Utilities Commissioners, as indicated above. We look forward to continuing this dialogue.

Sincerely,



Gordon van Welie
President and Chief Executive Officer

cc: Jeff Bingaman, Chair, U.S. Senate Committee on Energy and Natural Resources
Pete Domenici, Ranking Member, U.S. Senate Committee on Energy and Natural Resources
New England Congressional Delegation
New England Conference of Public Utilities Commissioners